CHAPTER 8

CAPITAL CONSUMPTION ALLOWANCES

This Chapter discusses one of the most important of the Treasury Department proposals -- replacement of the Accelerated Cost Recovery System and the investment tax credit with a capital cost recovery system that provides annual capital consumption allowances that approximate real economic depreciation. The proposed Real Cost Recovery System would increase productivity, give proper allowance for inflation, eliminate the "front loading" of deductions that encourages tax shelters, and make lower tax rates possible through a broader tax base.

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Current Law

The Accelerated Cost Recovery System (ACRS) was established by the Economic Recovery Tax Act of 1981 and generally governs depreciation allowances for tangible property placed in service after 1980. ACRS assigns all "recovery property" to a class with a specified recovery period and depreciation schedule. In general, recovery property is defined to include all depreciable property placed in service after 1980, except intangible property, property subject to amortization, and property for which the taxpayer properly elects a method of depreciation, such as the units of production method, that is not expressed in terms of years.

The pre-ACRS depreciation rules remain in effect for property placed in service by a taxpayer prior to 1981. In general, these rules require taxpayers to recover an asset's original cost less salvage value over its estimated useful life. Taxpayers can elect among several rates of recovery ranging from straight line to methods that are substantially accelerated. Certain taxpayers can elect to depreciate assets under a system employing prescribed industry-wide class lives, with additional rules for salvage values, retirement, repair deductions, and other matters (the ADR system).

ACRS differs from prior depreciation rules in many important respects. ACRS recovery periods are not based on the economic useful life of assets, and for most assets are significantly shorter than under prior law. ACRS employs accelerated depreciation schedules and also allows recovery of full original cost without reduction for salvage value. Thus, for most assets, ACRS allows much faster cost recovery and greater present value depreciation deductions than were obtainable under prior law.

ACRS classifies all personal property (other than public utility property) as three-year or five-year property. Automobiles, light trucks and research and experimentation property are the principal three-year property items, while most other personal property, including machinery and equipment, is recovered over five years. Most real property is classified as 18-year property, although some real property, including real property placed in service prior to March 16, 1984, qualifies as 10-year or 15-year property. Low-income housing is classified as 15-year property. Public utility property may be five-year, 10-year or 15-year property depending upon the class life of such property under prior law.

Under ACRS, foreign property (property used predominantly outside the United States during the taxable year) is subject to longer recovery periods than comparable domestic property. Generally, foreign personal property is recovered over 12 years and foreign real property is recovered over 35 years.

The ACRS depreciation schedules for three-year, five-year and ten-year property are based on the 150 percent declining-balance method switching to the straight-line method. The schedules reflect a half-year convention which halves the first year's depreciation rate regardless of when during the year the property is placed in service. No depreciation deduction is allowed in the year of disposition of personal property.

The depreciation schedule for 18-year real property, except for special transition rules, is based on the 175 percent declining-balance method switching to the straight-line method. The depreciation schedule for 15-year low-income housing is based on the 200 percent declining balance method switching to the straight-line method. First-year depreciation rates for 15-year and 18-year real property are reduced to reflect the number of months during the first year in which property is held in service. Depreciation deductions for real property are allowed for the year of disposition, based on the number of months during which the property was in service for that year.

Under ACRS, the cost of building components, such as air-conditioning and electrical systems, is not recoverable over periods shorter than the building's recovery period. The recovery period for a component generally begins at the later of the time the component or the building is placed in service. The cost recovery for the component is accounted for separately from the building. Substantial improvements to a building are treated as a separate property item entitled to a separate recovery period and depreciation rate.

A lessee who makes capital improvements to leased ACRS property may recover the cost of such improvements over the remaining lease term, if such term is less than the ACRS recovery period. If the lessor and lessee are related parties, however, leasehold improvements must be recovered over the ACRS recovery period, even if the remaining lease term is shorter.

A taxpayer may elect longer recovery periods than the prescribed ACRS recovery period, but in doing so must use the straight-line method for determining the depreciation allowance. A taxpayer may also elect to use the straight-line method over the ACRS recovery period.

Taxpayers may elect to establish mass asset accounts for assets where separate identification is impractical. Only assets of the same recovery class which are placed in service in the same year may be included in a single mass asset account. Gain or loss is not computed upon dispositions of items from a mass asset account, and instead all

proceeds from sales of items from a mass asset account are treated as ordinary income. Correspondingly, dispositions do not reduce the unadjusted basis of the mass asset account, so that original cost basis can be fully recovered over the class recovery period.

A special exception to ACRS allows taxpayers to expense a small amount of property used in a trade or business. For taxable years beginning before 1988, a taxpayer may elect to expense a maximum of $5,000 per year. The limit on expensing increases to $7,500 for taxable years beginning in 1988 and 1989 and to $10,000 thereafter. No investment tax credit may be taken on expensed property.

Generally, ACRS depreciation schedules apply to the unadjusted cost basis of an asset. However, if an investment tax credit is taken, the cost basis of an asset must be reduced by 50 percent of the amount of the credit before applying the depreciation rate. Gain or loss is generally recognized on the disposition (including retirement) of ACRS property. Gain or loss is computed with respect to the adjusted basis of property which reflects previously taken depreciation.

ACRS deductions are subject to recapture upon an asset's disposition. For all personal and most real property, all previously allowed depreciation constitutes ordinary income, up to the amount of gain realized. There is no depreciation recapture on property for which a straight-line method has been elected. Only the excess of ACRS deductions over the straight-line method is recaptured on residential rental property, low-income housing and property used predominantly outside the United States.

ACRS does not apply to intangible assets. Amortization allowances are available under current law for intangible assets of limited useful life that are used in a business or held for the production of income. Generally, amortization allowances are computed using a straight-line method. Certain income-producing properties, such as motion picture and television films, may be amortized under the income forecast method which allocates costs proportionately to income expected to be produced.

Reasons for Change

Mismeasurement of Inflation-Adjusted Income. Tax liabilities should be imposed on the basis of real economic income. In the case of investment in depreciable property, measurement of real economic income requires an allowance for the property's economic depreciation. If that allowance is understated, income from the investment is overtaxed and a tax disincentive is created which impairs capital formation and retards the economy's productive capacity. By the same token, overstating depreciation and thus understating income creates an artificial incentive for one form of investment over another, discriminates among companies within an industry, and encourages nonproductive, tax-motivated investment activity.

The proper measure of economic depreciation in any year is the amount of decline in the real value of an asset over the year, which is equal to the cost of replacing the lost productive value. Due to inflationary increases in replacement costs, pre-ACRS depreciation deductions for many assets understated actual economic depreciation and thus resulted in overtaxation of the income from such assets.

The cost recovery system introduced with ACRS eliminated the prior overtaxation of capital investment by providing for more rapid acceleration of depreciation deductions. ACRS, however, continued to base depreciation allowances on historic costs rather than current replacement costs, and thus left the present value of depreciation deductions tied to the rate of inflation. Moreover, at recently experienced levels of inflation, ACRS, in combination with investment tax credits, reduced effective tax rates on investment in depreciable assets substantially below statutory tax rates. Where effective tax rates are reduced substantially below statutory tax rates, the tax system is undertaxing real economic income.

Table 1 displays Treasury Department estimates, based on certain stated assumptions, of average effective tax rates for income from assets in the various ACRS classes. Table 1 demonstrates (1) the substantial extent to which ACRS and investment tax credits reduce effective tax rates, (2) the variance among ACRS classes in the extent to which ACRS and investment tax credits reduce effective tax rates, and (3) the volatility of effective tax rates in response to different inflation rates.

Table 1

Effective Tax Rates on Equity Financed Investments
with Various Rates of Inflation
for 46 Percent Taxpayer Under Current Law 1/

Asset class (years)	Inflation rate (percent) 0	5	10
3	-90	-8	22
5	-51	-3	19
10	-5	20	32
15	9	35	45
18	28	40	45

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November 23, 1984

1/ Assumptions: Real return after tax is four percent. The investment tax credit selected is the maximum allowable (six percent on three-year equipment and ten percent on five-, ten-, and 15-year equipment). Effective tax rates are the difference between the real before-tax rate of return and the real after-tax rate of return divided by the real before-tax rate of return.

Investment Distortions. The low or negative effective tax rates on ACRS property and the tax deferral resulting from accelerated depreciation allowances distort investment decisions in a variety of ways. First, ACRS disproportionately benefits capital-intensive industries and methods of production. Income from sectors of the economy without significant investment in depreciable property typically face higher effective tax rates. Second, ACRS favors existing businesses over new, start-up businesses, and tax paying businesses over those with tax losses. Accelerated cost recovery allowances are more likely to be used fully by established, profitable businesses than by new companies with substantial start-up costs or by loss companies without net income. The potential unavailability of ACRS benefits may in turn lead to tax-motivated acquisitions or combinations that permit the benefits to be used fully in the year incurred.

Finally, ACRS has fueled the growth of tax shelters. The low or negative effective tax rates on ACRS property, especially in the early years of acquisition, make possible the sheltering of an investor's unrelated income and the accompanying deferral of tax liability. This

encourages taxpayers to make otherwise uneconomic investments in order to obtain tax benefits. Also, the prospect of substantial up-front deductions encourages excessive churning of assets.

Investment distortions created by ACRS, investment tax credits and other capital cost recovery provisions hamper economic efficiency. The tax code effectively guides the allocation of capital, overriding private market factors and the individually expressed consumer preferences they represent. This undeclared government industrial policy has grown dramatically in scale and yet it largely escapes public scrutiny or systematic review.

Complexity. As with other provisions that distort accurate measurement of income, the cost recovery rules of current law generate complexity and add to the administrative and enforcement burdens of the Internal Revenue Service. As tax shelter activity has increased due to ACRS and other provisions that mismeasure income, anti-abuse rules have proliferated and the Internal Revenue Service has been required to devote additional resources to policing tax shelter investments. Moreover, whether or not abusive, tax shelters invite disrespect for the tax laws from those who perceive, correctly or not, that the laws are unfair and, hence, not worthy of compliance.

ACRS also contributes to complexity which extends beyond tax shelter investments, affecting potentially every taxpayer. For example, ACRS deductions and investment tax credits must be recaptured upon disposition of depreciable property to prevent ordinary income from being taxed at preferential capital gain rates. The recapture provisions are necessarily complex. While ACRS is not the sole reason for recapture rules, a taxpayer cannot obtain ACRS deductions without being exposed to such complexity.

Uncertainty. ACRS fails to take account of fluctuating inflation rates. As a consequence, taxpayers continue to face uncertainties about the likely effect of inflation on the real after-tax value of a depreciable asset. This, in turn, acts as a depressant on economic activity. Table 1 illustrates the variance of real effective tax rates at different rates of inflation. The certainty of obtaining inflation-proof cost recovery should be an effective stimulus to risk taking and investment.

Proposal

New capital cost recovery rules would be established that explicitly account for inflation and the real economic loss inherent in the use of assets over time. The new Real Cost Recovery System (RCRS) would modify ACRS in several important respects. First, RCRS would allow cost recovery of the real or inflation-adjusted cost of business assets, rather than only the original nominal cost. Second, RCRS would revise the assignment of property among recovery classes. Third, RCRS would assign an invariant percentage rate of depreciation to each recovery class, rather than having rates vary each year as under ACRS. Fourth, the percentage rate of depreciation for each

recovery class would be a measure of the estimated decline in economic value. The resulting RCRS depreciation allowances would measure more closely than does ACRS the real economic loss for all assets within a single class.

Under RCRS, all depreciable tangible assets would be assigned to one of seven classes, which would replace the present five ACRS recovery classes. Each RCRS class would be assigned an invariant depreciation rate, ranging from 32 percent to three percent. The depreciation rate would be applied to the indexed basis of an asset, as described below. The depreciation rates assigned to each class of assets and the assignment of types of assets to each class would be designed to minimize the variance in the effective tax rates for all assets, in light of real economic depreciation. Under RCRS, as under ACRS, taxpayers would not estimate useful lives and salvage values for each asset. Intangible assets would not be subject to RCRS and would be amortized generally under current law rules. In addition, assets such as motion pictures, that are depreciable under the income forecast method or other method not measured in terms of years would continue to be depreciable under rules similar to current law.

RCRS would adjust depreciation allowances for inflation by means of a basis adjustment. Under ACRS, only the unadjusted original cost basis of an asset is recovered over the class recovery period. Under RCRS, the remaining unrecovered basis of an asset would be increased each year by the inflation rate and the fixed depreciation rate applicable to the asset's class would be applied against the resulting adjusted basis. The basis of depreciable property not subject to RCRS would be indexed for inflation in a similar manner.

If an asset's basis were adjusted each year for inflation, applying a fixed depreciation rate of less than 100 percent to the adjusted basis would never fully recover such basis. To simplify accounting, RCRS would allow a taxpayer to close out its depreciation account for any asset in a particular class after a specified period of years. The close-out year is not an estimate of the economic useful life of assets in a particular class. The year in which depreciation allowances would be closed out would be the year for each class of assets in which 15 percent of the inflation-adjusted original basis remains to be depreciated. For example, an asset eligible for a 32 percent depreciation rate would be entitled to a 100 percent depreciation rate in the fifth year in which the asset is retained in service. An asset eligible for a 12 percent depreciation rate would be allowed a 100 percent depreciation rate in the 17th year in which the asset is retained in service.

In current dollar terms, the depreciation deduction in the close-out year would exceed substantially the annual deductions allowed in prior years. To mitigate this bunching effect, rules would be provided to spread the amount of the close-out deduction over a period of years. In addition, retirement of an asset prior to the

close-out year would be treated as a disposition, upon which a taxpayer would obtain full recovery of an asset's remaining basis and recognize gain or loss.

Under RCRS, taxpayers would pro rate first-year depreciation allowances based upon the number of months assets are placed in service. There would be a mid-month convention for prorating depreciation allowances in the month in which an asset is placed in service. There would be no half-year convention as is applied to personal property under ACRS. A similar pro rating would be required in the year of disposition. There would be no inflation adjustment to basis for purposes of determining depreciation in the year in which an asset is placed in service. There would be a pro-rata inflation adjustment to basis in the year of disposition.

The current law provision permitting taxpayers to elect to expense the aggregate cost of personal property not in excess of $5,000 would be retained. See Chapter 14.01. Vintaged mass asset accounts would also be retained for property qualifying for such treatment under current law. RCRS would retain the current law distinction between deductible repairs and expenditures that appreciably prolong an asset's useful life or materially add to its value, and thus, must be capitalized. Capitalized costs would generally be added to the adjusted basis of the underlying asset, subject to the appropriate partial-year convention or, in some cases, depreciated separately. Each RCRS class would be assigned a safe-harbor repair allowance factor. The safe-harbor would permit expenses incurred after the asset is placed in service to be deducted without challenge, if such expenses are allocable to the asset and do not exceed the product of the asset's remaining inflation-adjusted basis and the repair allowance factor.

Under RCRS, the cost of leasehold improvements that may be deducted by a lessee would be recovered under the general rules applicable to such property, regardless of the term of the lease. However, in the event leasehold improvements are reasonably expected to have no residual value upon termination of the lease term, special rules would be provided to permit different depreciation rates to be applied to such improvements, taking into account the term of the lease (including any renewal options and reasonably expected renewal periods). In the case of leasehold improvements depreciated by a lessee under the general rules, a lessee would treat the termination of a lease as a disposition of the leasehold improvements and would compute gain or loss upon the adjusted basis in such improvements.

The RCRS inflation-adjusted basis of an asset would be used to compute gain or loss on the disposition or retirement of the asset. Since the Treasury Department is also proposing to tax all real gains on sales or dispositions of property as ordinary income, there would be no provision for the recapture of previously taken depreciation. Since no investment tax credits would be available for

depreciable assets, there would be no provisions for the adjustment of basis due to such credits or for the recapture of the credits upon early disposition.

Table 2 lists the seven RCRS classes and assigns types of assets to each class. Table 2 specifies the depreciation rate for each RCRS class and the year in which a close-out deduction of all remaining basis may be taken.

The Treasury Department proposes to define the scope of each RCRS class by reference to existing ACRS classes in the following manner. All three-year ACRS property would be classified in RCRS Class 1. All 18-year ACRS property would be classified in RCRS Class 7. In addition, low-income housing, which is 15-year ACRS property, would be classified in RCRS Class 7. All ten-year ACRS property and 15-year public utility property would be classified in RCRS Class 6.

ACRS five-year property would be classified in RCRS Classes 2 through 5. Class 2 would encompass trucks (other than light purpose trucks which are three-year ACRS property), buses, and office, computing and accounting equipment. Class 3 would cover construction machinery, tractors, aircraft, mining and oil field machinery, service industry machinery and equipment and instruments. Class 5 would include railroad equipment, ships and boats, and engines and turbines. All other five-year ACRS property is grouped in Class 4. If an item of machinery, equipment or other property is not described by the asset types listed in Classes 2, 3 and 5, and is not reclassified specifically under the procedure described below, such item would be assigned to Class 4.

The constant depreciation rates for each RCRS class reflect Treasury Department empirical studies showing that a geometric pattern of constant-dollar economic depreciation is generally an appropriate method to apply to all classes of business assets, even though the geometric pattern may not accurately characterize all items within a class. Each of the seven RCRS classes that resulted from the Treasury Department studies is comprised of a group of asset types that, on average, have approximately the same observed geometric rate of economic depreciation. The RCRS classes are organized so as to minimize the variance in observed economic depreciation rates for assets within a class. (Treasury Department studies relied upon "The Measurement of Economic Depreciation," by Charles R. Hulten and Frank C. Wykoff in Depreciation, Inflation, and the Taxation of Income from Capital (ed. C. Hulten, 1981.)

The Treasury Department intends to continue conducting empirical studies of economic depreciation. The proposed RCRS system contemplates that the Treasury Department would establish permanent facilities to conduct these studies. Such studies would gather evidence of changing economic depreciation rates due to such factors as changing technological obsolescence or market conditions. In addition, the Treasury Department would develop data that would enable economic depreciation rates to be measured more precisely for specific

Table 2

RCRS Asset Classes 1/

RCRS Class	Depreciation Rate	Classification of ACRS Property	Close-Out Period (Years) 2/
Class 1	32%	3-year property	5
Class 2	24%	Trucks, Buses and Trailers, Office, Computing and Accounting Equipment	8
Class 3	18%	Construction, Machinery, Tractors, Aircraft, Mining and Oil Field Machinery, Service Industry Machinery, Instruments	12
Class 4	12%	5-year property not assigned to Class 2,3 or 5 including Metal Working Machinery, Furniture and Fixtures, General Industrial Machinery, Other Electrical Equipment, Electrical Transmission/Distribution Equipment, Communications Equipment, Fabricated Metal Products	17
Class 5	8%	Railroad Equipment, Ships and Boats, Engines and Turbines	25
Class 6	5%	10-year property; 15-year public utility property	38
Class 7	3%	18-year property; 15-year low-income housing	63

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1/ Items of property are assigned to RCRS classes under rules described in the text of the General Explanation.

2/ The close-out year is the year in which 15 percent of the inflation-adjusted original basis remains to be depreciated.

asset types. The Treasury Department would review data on economic depreciation and would promulgate regulations to reclassify asset types upon evidence that economic depreciation for an asset type deviates significantly from its class norm. The Treasury Department would also consider whether the depreciation rates for each class should be revised periodically. Pending development of an institutionalized process for reviewing economic depreciation rates, the Treasury Department proposes that ACRS property be classified among RCRS classes in the manner described above.

Effective Date

RCRS would be effective for property purchased on or after January 1, 1986 (other than property purchased pursuant to a binding contract entered into prior to January 1, 1986). Anti-churning rules, similar to those enacted as part of ACRS, would be provided to prevent a taxpayer from treating property owned prior to January 1, 1986, as being subject to RCRS on or after such date. In addition, anti-retention rules would be applied to prevent taxpayers who obtain ownership of assets on or after January 1, 1986, from continuing to account for such assets under ACRS or other prior law. However, assets acquired in tax-free liquidations and reorganizations would not be subject to RCRS if the basis of such assets carries over in the hands of a transferee.

Analysis

Neutral Capital Cost Recovery System. The Treasury Department proposals for the taxation of capital and business income include, principally, RCRS; inflation adjustment of inventories, interest income and expense and gain from the sale of most property; repeal of investment tax credits; and dividend relief. On the whole, these proposals would facilitate a lowering of statutory tax rates to 33 percent for corporations and 35 percent for the highest individual tax bracket. Moreover, RCRS, in concert with other inflation adjustment proposals, would ensure that effective tax rates throughout the economy would not vary significantly from the proposed statutory tax rates. In addition, effective tax rates would remain invariant if inflation were to fluctuate. Thus, RCRS would correct the three principal defects of the capital cost recovery system of current law (see Table 1) -- the substantial reduction in effective tax rates from statutory tax rates; the variance in effective tax rates among different assets and industries; and the volatility of effective tax rates in response to fluctuating inflation.

The economic neutrality among new investments in equipment and structures in different industries that would occur under RCRS is illustrated in Table 3. Under RCRS, the variance of effective tax rates from statutory tax rates across different industries is minor compared to the unsystematic distortions created under current law. There may be some significant variance in effective tax rates of several industries under RCRS, such as farming, mining, and

communications. The Treasury Department proposal contains a procedure for periodic adjustment of classifications, if actual effective tax rates under RCRS vary too widely from class norms.

Under RCRS, cost recovery allowances would no longer be front-loaded, as occurs under current law, due to the operation of accelerated depreciation rates and the investment tax credit. However, this does not mean that RCRS would be less valuable to taxpayers than ACRS would be after repeal of the investment tax credit. Tables 4 through 10 list present values of depreciation deductions available over the entire life of an asset under RCRS, ACRS, and straight-line methods. In many cases, RCRS produces a greater inflation-adjusted present value deduction than even ACRS. In all cases, RCRS produces the same present value deduction regardless of inflation rates, while ACRS and straight line methods, which recover original cost only, yield real present value deductions which decrease as inflation increases.

Comparisons of RCRS with current law should also consider the continued tax burden at the corporate and individual levels resulting from the integration of all of the Treasury Department proposals for taxing capital and business income. Table 11 presents the combined effective tax rates at the corporate and individual levels for various cost recovery systems and for the integrated Treasury Department proposal for cost recovery. Table 12 presents the same comparisons of effective tax rates at only the corporate level. In sum, Tables 11 and 12 show that the Treasury Department proposed capital cost recovery system, of which RCRS is a centerpiece, produces approximately the same effective tax rate on income from all forms of investment, while the alternative approaches produce widely varying effective tax rates that depend on the rate of inflation. With respect to many types of property, the Treasury Department proposal is more generous than the alternative approaches, including current law.

Simplicity and Fairness of RCRS. RCRS is designed to correct the previously mentioned defects in ACRS, while at the same time preserving the simplicity of a depreciation system based on relatively few classes of property, each of which would have a single constant depreciation rate to be applied to inflation adjusted basis. The hallmark of RCRS is the more realistic reflection of economic depreciation and thus a fair and more accurate measurement of real economic income.

For purposes of measuring real income, RCRS emphasizes the importance of taking into account not only inflation, but also dynamic factors, such as technological change and changing market conditions, which determine economic depreciation. In modifying the ACRS class-based system, RCRS does not revert to prior flawed methods of depreciation which depended upon determining each asset's useful life, without regard to the pattern of economic depreciation over such life.

The asset types classified in Table 2 are obviously broad categorizations of the myriad of depreciable assets. These asset

types are much broader than the categorization of assets under the ADR depreciation system which preceded ACRS. The seven RCRS classes however, are more differentiated and hence, fairer depreciation rates than are obtained under ACRS. ACRS has a single depreciation rate for assets as diverse as computers, service industry machinery and equipment, electrical equipment, and ships. The single ACRS depreciation rate applicable to these diverse assets may be simple in application, but it is neither fair nor conducive of efficient resource allocation.

The classification of assets under RCRS is not more complex than under ACRS. RCRS would be a relatively simple system for taxpayers to comply with and for the Internal Revenue Service to administer. Recordkeeping would be no more involved than under ACRS. Although there would undoubtedly be a need for regulations to refine technical classification of certain items of property, such regulations would not be more complex than existing regulations under ACRS. Class 4 would initially serve as a residual class for five-year ACRS propety not specifically classified in Classes 2, 3, or 5. The Treasury Department expects that further refinement of property classification would be possible as the Treasury Department conducts ongoing studies of economic depreciation for different assets and industries. Thus, the Treasury Department expects that additional items of five-year ACRS property which are classified in RCRS Class 4 could be reclassified among RCRS Classes 2, 3, or 5. Future studies might also justify reclassifying assets in RCRS Classes 1, 6, and 7. Similarly, the Treasury Department would evaluate periodically the appropriateness of depreciation rates and close-out periods assigned to each RCRS Class.

Simplification of Other Tax Provisions. RCRS and other proposed reforms of the capital cost recovery system of current law would permit a substantial simplification of the tax system. Even where some existing rules are retained, their significance and complexity to taxpayers and the Internal Revenue Service would be lessened with a more accurate measure of real income.

RCRS and repeal of the preferential capital gain tax rate would permit repeal of recapture rules. Such repeal would greatly simplify the tax treatment of dispositions of assets. RCRS would also permit repeal of various provisions governing the allocation of depreciation allowances, such as the special tax-exempt leasing rules and special recovery rules for lessees of property, although lessees would be permitted to take RCRS deductions. RCRS in combination with a uniform tax rate on capital and non-capital income would permit repeal of much of the corporate minimum tax. See Chapter 6.02.

RCRS should dramatically reduce the proliferation of tax shelters based on the accelerated capital cost recovery rules of current law. As a consequence, the significance of many anti-tax shelter rules, such as the at-risk rules, would be lessened. Fewer transactions would involve these provisions, enabling Internal Revenue Service enforcement resources to be committed elsewhere.

Table 3

Effective Tax Rates on Equity Financed Investments
in Equipment and Structures by Industry

Industry	Current law 1/ (percent) Inflation rate 5	Current law 1/ (percent) Inflation rate 10	RCRS Earnings 2/ Paid	RCRS Earnings 2/ Held
Agriculture	29	37	16	27
Mining	13	31	24	39
Logging	21	34	19	33
Wood products and furniture	28	38	20	34
Glass, cement and clay	20	31	20	34
Primary metals	16	28	19	33
Fabricated metals	28	38	19	33
Machinery and instruments	26	36	19	33
Electrical equipment	26	38	19	32
Motor vehicles	8	26	19	31
Transportation equipment	25	36	20	34
Food	25	35	19	33
Tobacco	18	30	19	33
Textiles	19	32	19	33
Apparel	28	38	21	34
Pulp and paper	12	26	20	34
Printing and publishing	22	34	19	33
Chemicals	19	32	20	33
Petroleum refining	12	2	19	32
Rubber	18	30	20	34
Leather	30	40	20	33
Transport services	9	26	21	34
Utilities	28	38	22	36
Communications	19	33	24	39
Services and trade	31	40	19	31

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November 29, 1984

1/ Current law assumes a 46 percent corporate tax rate.

2/ RCRS assumes a 33 percent corporate tax rate.
One-half of paid earnings are deductible.

Table 4

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 1 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 32 Percent Inflation: at 0%	RCRS Depreciation Rate 32 Percent Inflation: at 5%	RCRS Depreciation Rate 32 Percent Inflation: at 10%	ACRS: 3 Years	Straight-1: 3 Years
1	$160	$160	$160	$250	$167
2	269	282	296	380	333
3	183	202	221	370	333
4	124	144	165	0	167
5 2/	264	321	387	0	0
Nominal Total 3/	$1,000	$1,109	$1,229	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$1,000	$948	$930
Present Value 5/					
0% inflation	$924	N/A	N/A	$957	$944
5% inflation	N/A	924	N/A	908	879
10% inflation	N/A	N/A	924	865	824

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1/ Depreciation is computed on an asset placed in service on July 1 of year 1 by a calendar year taxpayer.

2/ The close-out year deduction would be spread over a period of years, a described in the General Explanation.

3/ Current dollars.

4/ Assumes 5 percent inflation rate.

5/ Assumes a 4 percent real rate of return.

Table 5

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 2 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 24 Percent : at 5% inflation	: at 10% inflation	ACRS : 5 Years	Straight-line : 5 Years
1	$120	$120	$150	$100
2	222	232	220	200
3	177	194	210	200
4	141	162	210	200
5	113	136	210	200
6	090	113	0	100
7	072	095	0	0
8 2/	239	330	0	0
Nominal Total 3/	$1,173	$1,383	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$904	$888
Present Value 5/				
5% inflation	$888	N/A	$837	$810
10% inflation	N/A	888	766	729

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See footnotes for Class 1 asset.

Table 6

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 3 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 18 Percent : at 5% inflation	RCRS Depreciation Rate 18 Percent : at 10% inflation	ACRS : 5 Years	Straight-line : 5 Years
1	$90	$90	$150	$100
2	172	180	220	200
3	148	163	210	200
4	128	147	210	200
5	110	132	210	200
6	95	119	0	100
7	81	108	0	0
8	70	97	0	0
9	60	88	0	0
10	52	79	0	0
11	45	71	0	0
12 2/	214	357	0	0
Nominal Total 3/	$1,264	$1,630	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$904	$888
Present Value 5/				
5% inflation	$847	N/A	$837	$810
10% inflation	N/A	847	766	729

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See footnotes for Class 1 asset.

Table 7

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 4 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 12 Percent : at 5% inflation	RCRS Depreciation Rate 12 Percent : at 10% inflation	ACRS : 5 Years	Straight-line : 5 Years
1	$60	$60	$150	100
2	118	124	220	200
3	109	120	210	200
4	101	116	210	200
5	93	113	210	200
6	86	109	0	100
7	80	105	0	0
8	74	102	0	0
9	68	99	0	0
10	63	96	0	0
11	58	93	0	0
12	54	90	0	0
13	50	87	0	0
14	46	84	0	0
15	42	81	0	0
16	39	79	0	0
17 2/	302	635	0	0
Nominal Total 3/	$1,444	$2,192	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$904	$888
Present Value 5/				
5% inflation	$781	N/A	$837	$810
10% inflation	N/A	781	766	729

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See footnotes for Class 1 asset.

Table 8

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 5 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 8 Percent : at 5% inflation	RCRS Depreciation Rate 8 Percent : at 10% inflation	ACRS : 10-Year	Straight-line : 10-Year
1	$40	$40	$80	$50
2	81	84	140	100
3	78	85	120	100
4	75	87	100	100
5	73	88	100	100
6	70	89	100	100
7	68	90	90	100
8	66	91	90	100
9	63	92	90	100
10	61	93	90	100
11	59	94	0	50
12	57	95	0	0
13	55	96	0	0
14	53	97	0	0
15	51	99	0	0
16	50	100	0	0
17	48	101	0	0
18	46	102	0	0
19	45	103	0	0
20	43	105	0	0
21	42	106	0	0
22	40	107	0	0
23	39	109	0	0
24	38	110	0	0
25 2/	455	1,389	0	0
Nominal Total 3/	$1,796	$3,652	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$819	$791
Present Value 5/				
5% inflation	$697	N/A	$707	$665
10% inflation	N/A	697	603	551

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See footnotes for Class 1 asset.

Table 9

Amount of Depreciation Allowances Under
Alternative Depreciation Schemes for Class 6 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 5 Percent : at 5% inflation	RCRS Depreciation Rate 5 Percent : at 10% inflation	ACRS : 15-Year	Straight-line : 15-Year
1	$25	$25	$50	$33
2	51	54	100	67
3	51	56	90	67
4	51	59	80	67
5	51	61	70	67
6	51	64	70	67
7	51	67	60	67
8	50	70	60	67
9	50	73	60	67
10	50	76	60	67
11	50	80	60	67
12	50	83	60	67
13	50	87	60	67
14	50	91	60	67
15	50	95	60	67
16	49	99	0	33
17	49	104	0	0
18	49	108	0	0
19	49	113	0	0
20	49	118	0	0
21	49	124	0	0
22	49	129	0	0
23	49	135	0	0
24	48	141	0	0
25	48	148	0	0
26	48	154	0	0
27	48	161	0	0
28	48	168	0	0
29	48	176	0	0
30	48	184	0	0
31	48	192	0	0
32	47	201	0	0
33	47	210	0	0
34	47	219	0	0
35	47	229	0	0
36	47	240	0	0
37	47	258	0	0
38 2/	936	5,231	0	0
Nominal Total 3/	$2,725	$9,877	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$743	$709
Present Value 5/				
5% inflation	$582	N/A	$603	$556
10% inflation	N/A	582	485	430

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See footnotes for Class 1 asset.

Table 10

Current Amount of Depreciation Allowances Under Alternative Depreciation Schemes for Class 7 Asset 1/
(per $1,000 investment)

Year	RCRS Depreciation Rate 3 Percent : at 5% inflation	RCRS Depreciation Rate 3 Percent : at 10% inflation	ACRS : 18-Year	Straight-line : 18-Year
1	$15	$15	$50	$28
2	31	33	90	56
3	32	35	80	56
4	32	37	80	56
5	33	39	70	56
6	33	42	60	56
7	34	45	60	56
8	35	48	50	56
9	35	51	50	56
10	36	55	50	56
11	37	58	50	56
12	37	62	50	56
13	38	66	40	56
14	39	71	40	56
15	39	76	40	56
16	40	81	40	56
17	41	86	40	56
18	42	92	40	56
19	42	98	20	28
20	43	104	0	0
30	53	200	0	0
40	63	382	0	0
50	76	731	0	0
63 2/	3,164	56,605	0	0
Nominal Total 3/	$6,633	$81,480	$1,000	$1,000
Inflation Adjusted Total 4/	$1,000	$1,000	$715	$666
Present Value 5/				
5% inflation	$445	N/A	$570	$502
10% inflation	N/A	445	454	377

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See footnotes for Class 1 asset.

REPEAL INVESTMENT TAX CREDIT

General Explanation

Chapter 8.02

Current Law

A credit against income tax liability is provided for a taxpayer's investment in certain depreciable property. Subject to a long list of exceptions, the following classes of property qualify for the investment credit: (1) tangible personal property (other than air conditioning or heating units); (2) certain other tangible property (not including buildings and their structural components); (3) elevators and escalators; (4) single purpose agricultural or horticultural structures; (5) rehabilitated buildings; (6) certain timber property; and (7) storage facilities (not including buildings and their structural components) used in connection with the distribution of petroleum or certain petroleum products.

In general, the credit is equal to ten percent of qualified investment in property that is placed in service during the taxable year. In the case of three-year property, the applicable credit rate is generally six percent. All qualifying costs for new property are eligible for the credit; in the case of used property, the qualifying costs that may be taken into account are generally limited to $125,000 for each taxable year.

The amount of tax liability that may be offset by investment credits in any year may not exceed $25,000 plus 85 percent of the tax liability in excess of $25,000. Credits in excess of this limitation may be carried back three years and forward 15 years.

Reasons for Change

The investment tax credit creates an investment incentive that favors some forms of economic activity over others, discriminates among taxpayers within a single industry, and encourages tax-motivated, noneconomic behavior. Because the investment credit is generally limited to investments in tangible personal property, it favors capital-intensive industries over labor-intensive industries. In addition, the ability of taxpayers to benefit from the credit depends on their having taxable income. Thus, start-up, fast-growing, and loss corporations typically derive less benefit from the credit than existing, profitable corporations in the same industries.

The investment tax credit also distorts investor behavior by skewing the relationship between pre-tax and after-tax returns on investment. Taxpayers are encouraged to invest in activities eligible for the credit or other preferences rather than activities which, in the absence of tax considerations, might produce a greater economic return. The intrusion of tax into economic life is shown most plainly

in the numerous tax shelter offerings which depend upon the investment tax credit and certain other deductions and credits for their viability. To the extent taxpayer energy and resources are consumed in pursuing tax rather than economic advantage, the growth and productivity of the economy as a whole are weakened.

Although the concept of the investment tax credit is straightforward, the applicable statutory provisions are exceedingly complex. Repeal of the credit would substantially simplify the tax system by eliminating these complicated rules.

Proposal

The investment tax credit would be repealed. See Ch. 15.01 for a discussion of repeal of the investment credit for rehabilitated buildings.

Effective Date

The proposal generally would be effective for property purchased on or after January 1, 1986 (other than for property purchased pursuant to a binding contract entered into prior to January 1, 1986).

Analysis

Repeal of the investment tax credit would result in more equitable and neutral tax treatment of business taxpayers by eliminating the preferential tax treatment for investments in certain types of assets. Repeal also would eliminate the variations in tax rates among firms that is caused by differences in their capacity to utilize credits. Table 1 shows the industry variations, which are often substantial, in the value of the investment credit. Industries with a low ratio of credit used to credit earned receive less benefit from the investment credit than industries that ordinarily can use the credit immediately. When combined with the impact of accelerated cost recovery, the variation shown in the table probably would be even larger.

Since repeal of the investment tax credit would eliminate the bias in favor of property that is eligible for the credit, investment in such property is expected to diminish. Aggregate business investment, however, should not be diminished. As a result of the benefits accruing to taxpayers from lower overall tax rates and the Treasury Department proposal for an indexed depreciation system, the tax rates on capital in the aggregate would be reduced. See Chapter 8.01.

Repeal of the investment tax credit also would eliminate complexity associated with existing rules (1) to distinguish qualified from non-qualified property, (2) to determine the amount of the credit, (3) to adjust basis as a result of the credit, (4) to determine the amount of previously allowed credits subject to

recapture in the event of early disposition of an asset, and (5) to carryback and carryforward unused credits. Other rules also would be repealed: the at-risk rules for the credit, the rules which deny the credit to certain noncorporate lessors, the rules governing pass-through of the credit, the definition of qualified United States production costs and other special rules for films and sound recordings, the rules governing property used by certain tax-exempt entities, the rules pertaining to the treatment of qualified progress expenditures, the rules denying the credit for foreign use property (other than property that meets one of eleven exceptions) and for certain property used in connection with the furnishing of lodging, the rules governing the credit for livestock, the rules governing the credit for certain boilers, and the rules distinguishing used and new property.

Table 1

Utilization of Tax Credits in 1981
($ Millions)

Industry	Investment Credit Earned	Investment Credit Used Against 1981 Tax Liabilities	Rate of Credit Used to Credit Earned (percent)	Unused Investment Credit
All manufacturing	$ 11,327	$ 9,116	80	$ 6,720
Food manufacturing	1,025	831	81	403
Tobacco manufacturing	144	151	105 1/	0
Textile mill products	146	125	86	83
Apparel	60	56	93	25
Lumber and wood	309	48	16	392
Furniture and fixtures	38	30	79	14
Paper products	373	303	81	207
Printing and publishing	482	345	72	218
Chemicals	1134	872	77	653
Petroleum and refining	2,332	2,295	98	209
Rubber and plastic	132	111	84	120
Leather products	20	19	95	4
Stone, clay and glass	264	148	56	242
Primary metals	492	649	132 1/	981
Fabricated metals	447	326	73	229
Machinery	1,166	938	80	420
Electrical equipment	1,081	631	58	1,080
Motor Vehicles	865	739	85	877
Transportation equipment	418	123	29	501
Instruments	296	293	99	24
Other manufacturing	103	81	79	42
Utilities	4,844	3,047	63	7,939
Other Sectors	9,831	6,649	68	8,022
Total	$26,002	$18,812	72	$ 22,681

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1/ Percentage greater than 100 indicates that credits were carried forward and used from previous years.